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BY RONALD R. CARPENTER

Court of Appeals No. 57866-9 CARPENTER

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IN THE SUPREME COURT
OF
THE STATE OF WASHINGTON

MUTUAL OF ENUMCLAW INSURANCE COMPANY,

and

COMMERCIAL UNDERWRITERS INSURANCE COMPANY,

Respondents,

v.

USF INSURANCE COMPANY,

Petitioner.

ANSWER OF RESPONDENTS

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A. ISSUES PRESENTED FOR REVIEW

1. Does USF's argument based on a claim of waiver, the facts for which have not been established, merit review?
2. Should the Court review whether Washington should abandon its well established late tender rule, requiring insurers to defend despite late tender in the absence of prejudice, in order to adopt the selective tender rule under which only the insured could determine whether a policy will apply?
3. Does the Court of Appeals' decision conflict with Washington cases on whether an unintentional late tender which prevented USF from investigating at the time of suit constitutes an extreme circumstance warranting finding prejudice as a matter of law even though the underlying cases were either resolved by arbitration or through litigation followed by arms length negotiation?
4. Does the Court of Appeals decision conflict with Washington authorities on equitable remedies?

B. STATEMENT OF THE CASE

Dally Homes, Inc. was the contractor and developer who built the Windsong Arbor Condominiums in the mid-1990's. CP 34. Dally was insured by Commercial Underwriters Insurance Company (CUIC) until it switched to USF Insurance Company

(USF) on January 18, 2000. CP 34, 46. Mutual of Enumclaw (MOE) also insured Dally for a time through an additional insured endorsement obtained by one of Dally's subcontractors on the project. CP 35.

The Windsong Arbor Homeowners' Board of Directors became concerned that the Condominium Act statute of limitations might run leaving them without a remedy if construction defects were later discovered. CP 91 – 92. In December of 1999 the Board hired Mark Jobe, a construction expert, to determine whether the project was defective. CP 91, 93. Mr. Jobe reported back to the Board at its January 20, 2000 meeting. CP 91. At that meeting the Board learned for the first time that there were significant defects that required repairs. CP 91 – 92. This was two days after Dally's USF policy became effective. CP 46.

The Board also sought a lawyer to advise them if significant defects were found and selected James Skeen to find lawyers to interview. CP 90 – 92. Sometime in December 1999, Mr. Skeen called Richard Beal and asked whether he might be available to represent the Board. CP 327 – 328. Skeen was careful to say it was uncertain whether significant defects existed. CP 345. Although Mr. Beal cannot remember what was said, he concluded

there was a risk his sometime client Dally Homes would be sued and obtained permission to warn Don Dally, the Company's President. CP 345.

Mr. Beal had represented Dally Homes in an earlier action by another condominium owner's association. CP 331, 364 – 365. Since that time Dally looked to him from time to time for advice on insurance issues. CP 364 – 365. In addition, Beal "kept his ear to the ground" for rumors implicating Dally's projects. CP 331. After receiving permission to warn Dally, Beal tried to contact him. CP 331 – 332.

Because of the attenuated nature of their contact Beal could not remember Dally's telephone number. CP 332. He believes he called from his office. CP 332. Although when first asked Beal thought he reached Dally before the January 18, 2000 inception of USF's policy, he later determined, based on Mr. Dally's phone log, their contact occurred on January 20th, two days after the policy bound. CP 331 – 332. This was confirmed by Mr. Dally. CP 359 – 361.

Real estate agent Loren Kenkman heard a rumor Windsong Homeowners were meeting on January 20th to discuss a possible construction defect lawsuit against Dally Homes and told Don

Dally. Although when deposed nearly six years later Mr. Kenkman guessed learned of the January 20th meeting as much as two weeks in advance and told Dally either that day or the following day, Mr. Dally testifying from his "Daytimer" log established January 18th as the date of Mr. Kenkman's call, several hours after the USF policy bound at 12:01 a.m. (CP 370-371, 352, 359-360, 46).

Several months later Windsong sued Dally. Dally tendered its defense to MOE and CUIC, but did not tender to USF. CP 35. MOE and CUIC defended Dally through months of litigation. CP 35. When push came to shove it was apparent that a very substantial recovery was possible. CP 35. CUIC and MOE provided the money to settle the case at approximately half the total risk. CP 35. As part of the settlement they received an assignment of Dally's rights to pursue other insurance companies and the subcontractors. CP 35.

MOE and CUIC brought actions against other insurers and the subcontractors recovering back a significant portion of their outlay to settle the case. CP 36. After all of this was done it was discovered that USF also insured Dally for this risk with a policy that became effective two days before the Windsong Arbor Board

learned of their condominium's defects at the January 20, 2000 meeting. CP 36. After USF rejected an invitation to contribute CUIC and MOE brought this action against it. CP 36.

USF obtained dismissal of the action by Summary Judgment Motion. CP 576 – 579. USF successfully defended its Summary Judgment on reconsideration. CP 598 – 599. CUIC and MOE obtained a reversal of USF's Summary Judgment in the Court of Appeals. *Mutual of Enumclaw Insurance Company v. USF Insurance Company*, 137 Wn. App. 352 (2007). It is that reversal which USF has asked the Supreme Court to review.

C. ARGUMENT

1. USF'S Waiver Theory Does Not Merit Review

USF attempts to show the Court of Appeals' decision is in conflict with other Washington decisions by arguing the Court of Appeals failed to subject MOE and CUIC to the waiver defense, based on USF's claim Dally Homes waived its rights under the USF policy causing its assignment to MOE and CUIC to be vulnerable to that defense. The record shows that Dally Homes did not waive its rights under the policy because it was unaware of them. In addition, even if USF's take on the record is correct, it would require the evidence relating to Dally Homes' subjective

knowledge (the known loss defense) to be resolved at trial, as the Court of Appeals required.

USF has the burden to prove waiver. *Jones v. Best*, 134 Wn.2d 232, 241-242, 950 P.2d 1 (1998). Whether there was waiver is dependent upon what Dally knew. Waiver is the voluntary relinquishment of a known right and "one cannot waive that which he does not know or where he has acted under a misapprehension of facts." *Mid-Century Insurance Co. v. Brown*, 33 Wn. App. 291, 296, 654 P.2d 716 (1982). Dally's subjective knowledge is also the basis for the known loss defense which the Court of Appeals has required USF to establish at trial.

Insurance is only available to cover an uncertain risk. If an insurance purchaser knows a loss has already occurred insurance is not available. The known loss defense requires the insured to have actual subjective knowledge rather than mere notice of the loss. See, *Overton v. Consolidated Insurance Co.*, 145 Wn.2d 417, 425, 38 P.3d 322 (2002). The subjective knowledge must be sufficient for the insured to know there is a substantial probability of a claim or property damage that will produce a claim. *Ibid* (subjective knowledge); *Hillhaven Property Ltd., v. Sellen Const. Co.*, 133 Wn.2d 751, 767-768, 948 P.2d 796 (1997) (substantial

probability). Evidence that is merely suggestive is inadequate. For example, evidence of annoying water leaks was insufficient to provide knowledge of significant hidden water damage in *Hillhaven*.¹

Two persons are said to have warned Dally of a possible lawsuit, Mr. Beal, a lawyer, and Mr. Kenkman, a real estate agent. Neither Beal nor Kenkman had more than uncertain information that a claim might be coming. Mr. Beal cannot remember what he was told, only that he concluded that Dally might be sued. CP 345. Mr. Kenkman testified he wasn't aware of any actual construction defects. CP 375. He only heard there was to be a meeting about a possible claim. CP 370-371. No one at Windsong knew there was even a claim of actual defects until the January 20th meeting, two days after the policy bound. CP 91-92.

According to Mr. Dally neither Beal nor Kenkman was able to tell him their concerns until after the USF policy bound. The most that can be said in USF's favor on this point is that there is a conflict between the date established by Mr. Dally with his

¹ A USF Policy endorsement excludes "Preexisting damages and/or defects known to any insured" also requiring actual subjective knowledge. CP 78.

"Daytimer" log and the guesses Mr. Kenkman made in his deposition more than five years after the event.

USF has argued that Mr. Beal's "knowledge" must be imputed to Dally Homes claiming that Mr. Beal was its authorized agent and because Mr. Beal is a lawyer. Imputation is not possible under either theory. When subjective knowledge is required, as it is here for a known insurance loss, the law does not impute the knowledge of either an agent to his principal or a lawyer to his client.

Although it does not appear Mr. Beal was acting as a lawyer for Dally at the time he talked to Windsong Board member Mr. Skeen, even if he were it is not proper to impute the lawyer's knowledge to the client in situations in which the "client's rights or liabilities require proof of the client's personal knowledge or intentions. . . ." *Restatement 3rd, The Law Governing Lawyers*, Chapter 28 (1). Subjective knowledge is required for a known loss. *Overton*, 145 Wn.2d at 425; and *Hillhaven*, 133 Wn.2d at 767-768.

The same rule limits imputation of an agent's knowledge to his principal. The Restatement of Agency distinguishes between formal notification and the legal requirement of "knowledge in a subjective sense." *Restatement 2nd, Agency*, § 275, comment b.

The subjective knowledge of an agent is imputed to his principal only when the agent is acting for the principal in the transaction in which the knowledge arises, or when the principal has misled the person with whom the agent is dealing by creating apparent authority in the agent, causing misdelivery of information to the agent. *Restatement 2nd, Agency*, § 273. The subjective knowledge requirement coupled with the fact Mr. Beal was not acting for Dally in any transaction prevents the imputation of Beal's knowledge to Dally.

USF's argument that the Court of Appeals' decision conflicts with other Washington cases fails because the evidence demonstrates Dally Homes was unaware of the potential claim until after the USF policy bound or in the alternative USF failed to prove Dally knew of the loss before its policy bound, requiring a trial. The most USF can demonstrate is a potential conflict of testimony between Mr. Dally and Mr. Kenkman about when Mr. Kenkman's warning occurred, a purely factual issue. The Court of Appeals' opinion is consistent with the applicable Washington authorities. USF fails to demonstrate a basis for review.

2. **USF'S Selective Tender Proposal Is Contrary To Established Washington Case Law As Well As Its Own Policy**

USF argues that because Dally knowingly chose to withhold tender from USF it should be excused from paying its share even without showing USF was prejudiced. This argument ignores Dally's mistaken reliance of the known loss issue in withholding tender, Washington's well established late tender rule requiring USF to demonstrate it was prejudiced, and the "other insurance" clause in USF's policy. In the previous section of this Answer it was demonstrated either Dally did not actually know of the loss before the USF policy bound or that sufficient facts to establish a known loss have not been shown. This section will deal with the impact of the late tender rule and USF's "other insurance" clause.

USF cites cases from other states for the proposition that in those states the policy is triggered by tender. Washington law is dramatically different than the law of Montana and Illinois. In continuing damage cases like the case against Dally in which defects created continuing interior dampness and rot, the policies are triggered in the first instance by the occurrence of damage, even without the filing of the lawsuit. *Gruol Construction, v. Insurance Co. of N. America*, 11 Wn. App. 632, 636, 524 P.2d 427

(1974). Under this approach the policies of all insurers on the risk from the time the construction was completed until the damage is discovered are triggered. *Id.* at 633-635. As a result, even before the action was brought against Dally, all three policies were triggered by continuing damage at the Windsong Arbor Condominiums.

The insurer's duty to defend is activated when "a complaint against the insured, construed liberally, alleges facts which could, if proven, impose liability upon the insured within the policy's coverage." *Uniguard Ins. Co., v. Leven*, 97 Wn. App 417, 425, 983 P.2d 1155 (1999). An insurer does not actually have to take up the cudgel to defend until a defense is requested, however. *Id.* at 427. The scope of the duty to defend is both broad and durable, capable of surviving the insured's breach unless the insurer is actually and substantially prejudiced. *Griffin v. Allstate*, 108 Wn. App. 133, 141, 29 P.3d 777 (2001). An insurer must pay pre-tender defense costs unless the late tender has actually prejudiced it. *Id.* at 142. It is not whether the insured was aware of the potential coverage, but whether the insurer was prejudiced by late notice that is the key. See, *Uniguard Ins. Co., v. Leven*, 97 Wn. App 417, 983 P.2d 1155

(1999). USF must pay its share unless it can show the late notice caused it actual and substantial prejudice.

USF's argument is contrary to the contractual terms of its own policy. Its policy contains an "other insurance" clause which contemplates the sharing of the insurance burden with other insurers who provide coverage for the loss. CP 61, paragraph 4.c. The other insurance clause in an insurer's policy has been used in Washington to compel the insurer to contribute to the loss. *Kirkland v. Ohio Casualty Insurance Co.*, 18 Wn. App. 538, 546, 569 P.2d 1218 (1977). In that case Ohio Casualty was required to pay its share to another insurer under the "other insurance" clause despite its argument that an insurance policy is a personal contract with the insured. *Id.* at 544 and 546. The court pointed out that the Ohio Casualty policy contemplated contribution among the obligated insurers and that to hold otherwise would provide Ohio Casualty a windfall after it had accepted premiums based upon the total exposure to the loss. *Id.* at 546. USF's other insurance clause and its acceptance of premiums to cover the loss obligates it to contribute its share.

While arguing that Washington should change its case law in order to adopt the selective tender rule USF makes the surprising

claim that the selective tender rule “is in total harmony with Washington law.” USF’s Petition for Review at 16. This statement ignores the basis for *Uniguard Ins. Co., v Leven*, which requires an insurer to show prejudice in order to enforce a breach of its policy’s notice provision. It ignores the late tender rule established by *Griffin v. Allstate*. It ignores *Kirkland v. Ohio Casualty* just discussed and the impact of its own “other insurance” clause.

USF’s proposed selective tender rule is inequitable to insurers who pay and rewards foot dragging by insurers who do not pay. It could reduce the number of policies available to provide payment to innocent third party claimants. The selective tender rule provides little inducement to change established Washington case law.

3. USF Did Not Suffer Prejudice As A Matter Of Law

USF attempts to argue the Court of Appeals decision is contrary to other Washington cases because of its refusal to find USF was prejudiced as a matter of law. Prejudice will only rarely be established by summary judgment in extreme cases. This is not a proper case to find prejudice by summary judgment because it is not extreme and as a result not appropriate for a finding of prejudice as a matter of law.

The Court of Appeals correctly held, based on Washington case law, even if the insured breaches the insurance contract, an insurer must prove the breach caused it actual and substantial prejudice in order to avoid the duty to defend. Prejudice will rarely be found by summary judgment because it is usually an issue of fact, and in the absence of prejudice the insurer must pay the costs of pre-tender defense. *Mutual of Enumclaw v. USF*, 137 Wn. App. 352 at 360-361 (2007) citing *Uniguard*, 97 Wn. App at 427 (actual and substantial prejudice); *Tran v. State Farm*, 136 Wn.2d 214, 228, 961 P.2d 358 (1998) and *Canron, Inc., v. Federal Ins. Co.*, 82 Wn. App. 480, 481, 918 P.2d 937 (1996) (rare), *Griffin*, 108 Wn. App. at 136 (pre-tender expense).

USF begins its argument by stating, misleadingly, that MOE and CUIC “waited four years” before asking USF to pay its share. USF’s Petition for Review at 19-20. That is not correct. MOE and CUIC only learned of the USF policy after settlement of the underlying action and completion of the suits against other insurers and the subcontractors to obtain their share. CP 36. This reason for the late tender is one of many factors the Court could consider in determining whether this case merited a finding of prejudice as a matter of law.

The rule requiring an insurer to show actual and substantial prejudice is based on the idea that policy provisions setting up conditions like notice and cooperation, which must be met by an insured, were placed in the policy to avoid prejudice to the insurer. Relieving the insurer of its duties without a showing of actual prejudice would provide a windfall to the insurer at the expense, not only of the insured itself, but potentially to innocent third-party claimants as well. *Oregon Automobile Ins. Co., v. Salzberg*, 85 Wn.2d 372, 376-377, 535 P.2d 816 (1975) and *PUD No. 1, v. International Ins. Co.*, 124 Wn.2d 789, 803, 881 P.2d 1020 (1994). An insurer must prove actual and substantial prejudice by showing specific causes of prejudice, how the prejudice affected its ability to investigate the claim, and resulting concrete detriment to the insurer. *Cannon, Inc., v. Federal Ins. Co.*, 82 Wn. App. 480, 486, 488-492, 918 P.2d 937 (1996).

The determination of whether to presume prejudice from a tender so late it deprives an insurer of the ability to investigate and participate in the defense is dependent upon an analysis of a variety of factors. In general, if it appears from the facts that the insured has pulled a fast one, prejudice is likely to be presumed. On the other hand, if the resolution of the case appears have been

reasonable and the delayed tender not calculated to hamper the insurer, the insurer is unlikely to have suffered presumable prejudice. See, *PUD No. 1, v. International Ins. Co.*, 124 Wn.2d 789, 803-805, 881 P.2d 1020 (1994) (settlement without insurer consent done with court approval – no prejudice); *Pilgrim, v. State Farm*, 89 Wn. App. 712, 950 P.2d 479 (1997) and *Tran v. State Farm*, 136 Wn.2d 214, 961 P.2d 358 (1998) (facts highly suggestive of fraud - prejudice); *Felice v. St. Paul Fire & Marine Ins. Co.*, 42 Wn. App. 352, 711 P.2d 1066 (1985) (intentional delay of tender to known insurer – prejudice); *Pulse v. Northwest Farm Bureau Ins., Co.*, 18 Wn. App. 59, 566 P.2d 577 (1977) (discovery of insurance coverage after trial – no prejudice).

An interesting recent case examines how to distinguish the two types of cases, those extreme cases in which prejudice is presumed and those not so extreme cases in which prejudice must be proved by the insurer to avoid coverage. *Northwest Prosthetic, v. Centennial Ins. Co.*, 100 Wn. App. 546, 997 P.2d 972 (2000). In *Northwest* the insured intentionally delayed tender on the brink of trial while negotiating an expensive settlement carefully crafted to appear to come within the coverage of the policy. The court found prejudice as matter of law distinguishing the *Canron* and *Pulse*

cases. The court noted that unlike the *Canron* case Centennial did not have extensive documents available to help it with an investigation after the fact. It distinguished *Pulse* on the basis it achieved a clear-cut result that was essentially beyond dispute. It pointed out in *Pulse* the damages were concrete as opposed to the nebulous damages for defamation in the *Northwest* case, the action in *Pulse* was actually tried to a court under circumstances suggesting the insurer could not have done better, the large settlement in *Northwest* had been cleverly labeled as a potentially covered defamation claim rather than the apparently more substantial but non-covered termination claim. *Northwest*, 100 Wn. App. at 554-555. The court concluded, “under these circumstances, unlike *Pulse*, one cannot be confident that the litigation accurately established the value of the claim.” *Id.* at 555.

The circumstances of construction defect litigation, like the case against Dally which underlies this case against USF, show the claim's value was accurately established. First construction defect cases feature concrete, ascertainable physical damage unlike the ethereal defamation claim in *Northwest*. Second, when both the insured and its insurers are involved in resolving construction defect cases the settlements are hammered out in tough

negotiations. Both the insured and the insurers are motivated to minimize the cost of settlement. The insured needs to preserve insurance coverage for other potential claims and the insurers, who must actually pay, need assurance the amount is not inflated. Third, when insurers are involved, the case cannot be resolved by dumping the entire claim into a covered category, ignoring exclusions which would lower the cost. The insurers would not accept such a ruse. Fourth, absent evidence from USF showing mistakes or the failure to raise appropriate defenses for Dally, there is no basis to suggest USF would have produced a better result had it participated in the defense of Dally. Fifth, during the eighteen months this case was litigated USF had an opportunity to obtain in discovery documentation of the damages in the underlying case against Dally permitting an after the fact investigation. Sixth, the shares of the subcontractors and other insurers (which reduce USF's share) were litigated in arbitration hearings which like the *Pulse* case, lend credence to those amounts. Seventh, the underlying case against Dally was litigated for months producing the record upon which its ultimate negotiation was based. Eighth, MOE and CUIC did not withhold notice to USF, but rather provided it notice shortly after discovering its policy. These factors assure the

claim was accurately determined despite USF's absence from the defense and that there was no attempt to place it at a disadvantage with late notice. As a result USF is unable to show it was prejudiced as a matter of law. The Court of Appeals correctly withheld finding prejudice as a matter of law based on Washington cases. Review is not merited.

4. The Court of Appeals' Decision Does Not Conflict With Washington Authorities on Equitable Remedies

USF argues the Court of Appeals' decision conflicts with other Washington cases on equitable remedies. Whether this action works an inequity upon USF depends on whether USF was prejudiced by late tender. It was not. That issue has been addressed above.

There are other significant equitable considerations. Washington encourages insurers to pay when coverage and liability are reasonably established and to allocate the relative responsibility among the insurers after payments. WAC 284-30-330(6). Our courts are sensitive to providing sufficient insurance coverage for the claims of innocent third parties to the extent fairness to insurers is not compromised. *Salzberg*, 85 Wn.2d at 376-377. Washington has made a strong commitment to requiring co-obligors to pay their

proper shares of their obligations. *Sound Built Homes, Inc. v. Windemere Real Estate*, 118 Wn. App. 617, 72 P.3d 788 (2003). USF's arguments appear to be motivated by the desire to avoid paying its share without having to make any showing of specific facts creating demonstrable concrete prejudice to it. USF's equitable arguments do not merit review.

D. CONCLUSION

MOE and CUIC ask the Court to reject USF's Petition.

Respectfully submitted this 18th day of July, 2007.

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